

No. 82-1387

Office-Supreme Court, U.S.

FILED

MAR 18 1983

ALEXANDER L. STEVAS,

CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1982

SANFORD S. ZACK, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

**ON PETITION FOR A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS FOR
THE SIXTH CIRCUIT**

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In this federal income tax case, petitioner seeks review of the decision below holding him liable for fraud penalties aggregating \$227,339.19, in addition to deficiencies in tax for the years 1959 through 1965 totalling \$453,297.37 (C.A. App. 96).¹ The decision turns on the credibility of the evidence and presents no question worthy of further review.

The pertinent facts may be summarized as follows: During the years in issue, petitioner operated a home improvement business in the Detroit, Michigan area (43 T.C.M.

¹The opinion of the court of appeals (Pet. App. A-2 to A-4) is reported at 692 F.2d 28. The opinion of the Tax Court is unofficially reported at 43 T.C.M. (CCH) 50 (1981). Petitioner has not reproduced the opinion of the Tax Court in the appendix to his petition. Accordingly, we are lodging 10 copies of the Tax Court's opinion with the Clerk for the convenience of the Court.

(CCH) 50, 51-52 (1981)). In 1964, the Internal Revenue Service initiated an investigation of petitioner's income tax liability for 1962 and 1963. The investigating agent was not able to reconcile the records he was shown with the petitioner's tax returns and concluded that petitioner's records were inadequate. Upon obtaining bank records of petitioner's accounts, the agent discovered that petitioner's deposits far exceeded the gross receipts reported on his tax returns. In order to determine petitioner's correct tax liabilities for the years 1959 through 1965, the Commissioner used the bank deposits method of reconstructing income. He disallowed certain unsubstantiated costs and other items claimed as deductions on petitioner's returns, including items reflected in fictitious invoices. Based on that computation, the Commissioner determined deficiencies reflecting understatements in petitioner's annual income ranging from \$75,838.98 to \$246,606.77 (*id.* at 59-61).

In the Tax Court, petitioner conceded that he understated his business receipts and overstated certain expenses on his tax returns, but contended that he did so in order to conceal from the government certain rebates or advances to customers he allegedly had made. He claimed that these rebates were deductible and would offset the understatements of income. Petitioner alleged that, in order to induce his customers, who often were already in debt, to purchase home improvements, he offered to increase the job price to be listed on the FHA credit application by the amount of debt the customer already owed. Petitioner stated that he would make cash advances with his own funds so that the customer could pay off his bills. Upon completion of the work, petitioner claimed that he would receive from the bank a check for the full amount of the home improvements supposedly made, which included the amount of any cash advances already made to the customer (43 T.C.M. (CCH) at 52, 53).

The evidence showed, however, that during the investigation and up to August 25, 1972, petitioner consistently denied making any payments of FHA loan proceeds to his customers. In each of hundreds of FHA loan applications, petitioner was required to, and did, verify that no cash payments or rebates had been made to his customers as an inducement. Petitioner also denied making such payments in statements made to the FBI and to a bank (*id.* at 52, 53).

The Tax Court, "having the opportunity to observe the demeanor of the witness and to compare his sworn testimony with his prior actions, found petitioner wholly unworthy of belief" (*id.* at 70).² As the court stated (*ibid.*):

The Court finds it difficult to believe that an individual who was so willing to tell so many lies to so many people over such a long period of time is now telling the truth.

As a result, the Tax Court determined that substantial deficiencies existed in all years in issue.

In addition to the seven consecutive years of substantial underpayments, the Commissioner presented substantial proof of petitioner's fraudulent intent, including the following "badges of fraud": (1) petitioner caused his accountants

²Contrary to petitioner's claim (Pet. 4), the Tax Court found that a survey of petitioner's former customers, conducted jointly by petitioner and the Commissioner, was "inconclusive" and did not support petitioner (see 43 T.C.M. (CCH) at 66). The customers had no documentary proof of the payments and had no independent recollection of the amounts, but simply tended to agree with whatever amount petitioner suggested. In addition, contrary to petitioner's statement (Pet. 4 n.3), two to four customers flatly denied receiving payments (43 T.C.M. (CCH) at 62). Moreover, when the same customers had previously been interviewed, they denied having received payments from petitioner (*id.* at 59-62). Finally, petitioner's suggestion (Pet. 4) that he may have been improperly prevented from presenting his case is baseless; he agreed without reservation to the use of the survey (Tr. 50).

to report false figures on his returns; (2) petitioner engaged in "virtually a pattern of deception" designed to conceal facts from the IRS; (3) petitioner failed to keep adequate books and records; (4) petitioner dealt extensively in cash; (5) petitioner failed to report specific items of income and submitted fictitious invoices for 1962 and 1963. Accordingly, the Tax Court held that petitioner's underpayments were attributable to fraud, that he was liable for the 50% addition to tax for fraud under 26 U.S.C. 6653(b), and that assessments of the deficiencies were not barred by the statute of limitations under 26 U.S.C. 6501(c)(1) (43 T.C.M. (CCH) at 68-69, 71). The court of appeals affirmed (Pet. App. A-2 to A-4).

1. Petitioner conceded below that he had falsely understated receipts and overstated deductions shown on his tax returns, with the result that his income was understated by hundreds of thousands of dollars (43 T.C.M. (CCH) at 61-63). He argues (Pet. 5-9), however, that, as part of the Commissioner's burden on the civil fraud question, the Commissioner must affirmatively prove that petitioner did not in fact have unclaimed deductions offsetting his unreported income.

Contrary to petitioner's repeated claim (Pet. 3, 5, 9, 12), the Commissioner in fact submitted substantial evidence that he had not made the payments to his customers he now claims to have made, and the Commissioner did not rely simply on the presumption of correctness. First, petitioner conceded that, in hundreds of FHA applications, he verified, subject to felony punishment if false, that he had not made payments of loan proceeds to customers (43 T.C.M. (CCH) at 69). Second, petitioner denied making such payments in statements to a bank, and to government agents in the course of their official duties (*ibid.*). Third, petitioner's tax returns, which he verified under penalty of perjury to be

"true, correct and complete," showed no such payments (Jt. Exhs. 1-A to 7-G). Petitioner's case was ultimately based on his testimony that he had made the payments he previously denied making. Based on petitioner's prior statements, his demeanor, and the serious inconsistencies and gaps in his story, the court concluded that his testimony was not worthy of belief (43 T.C.M. (CCH) at 70). This is a factual finding that does not warrant further review. *Comstock v. Group of Institutional Investors*, 335 U.S. 211, 214 (1948).

Furthermore, while the Commissioner is required to establish that the returns were fraudulent, even in criminal tax cases where the government has a higher burden of proof, proof of unreported income shifts to the taxpayer the burden to explain that omission, and where the taxpayer fails to meet that burden, the courts will find that an underpayment exists. *Siravo v. United States*, 377 F.2d 469, 473 (1st Cir. 1967); *United States v. Burkhardt*, 501 F.2d 993, 995 (6th Cir. 1974), cert. denied, 420 U.S. 946 (1975); *United States v. Bender*, 218 F.2d 869, 871-872 (7th Cir.), cert. denied, 349 U.S. 920 (1955). This rule is supported by basic rules of allocation of burdens (see *McCormick on Evidence* 787 (Cleary 2d ed. 1972)) and applies *a fortiori* in a civil case. *Rivera v. Commissioner*, 38 T.C.M. (CCH) 1338, 1344 (1979).

Here, petitioner's concession that he falsely understated his gross income in the years at issue by hundreds of thousands of dollars imposed the burden on him to show that this unreported income was offset by unclaimed deductions. However, petitioner wholly failed to meet that burden. Indeed, the Tax Court found the petitioner's self-serving, uncorroborated explanation to be incredible. Moreover, even if petitioner's testimony were fully accepted,

there would still remain substantial underpayments in all years at issue but one.³

Petitioner further tacitly assumes (Pet. 9-13) that he bore the burden to disprove the correctness of the Commissioner's determination, but argues that he proved that he made

³At all events, as the court of appeals held (Pet. App. A-3 to A-4), petitioner's description of the burden of proof in the Tax Court is wrong. It is well established that the Commissioner's determination of tax liability is presumptively correct and places on the taxpayer both the burden of going forward with the evidence and the burden of persuading the court that it is erroneous. *Helvering v. Taylor*, 293 U.S. 507, 515 (1935); *Welch v. Helvering*, 290 U.S. 111, 115 (1933); R. 142(a), Rules of Practice and Procedure of the United States Tax Court (May 1, 1979).

Where, as here, the taxpayer failed to meet his burden of persuading the court that the Commissioner's determination was erroneous, the existence of the deficiency was then established as a fact. The next question was whether any part of the deficiency was attributable to the taxpayer's fraudulent intent. A statutory exception to the general rule places the burden of proof on the issue of fraudulent intent on the Commissioner. See 26 U.S.C. 7454(a); R. 142(b), Rules of Practice and Procedure of the United States Tax Court (May 1, 1979). However, there is nothing in the statute or the Tax Court Rules to support petitioner's claim that the deficiency must be proved twice—once for the deficiency and once again for fraud. Indeed, although courts generally hold that the existence of substantial deficiencies, by itself, is insufficient to support a finding of fraud, where there is additional independent evidence of fraud, the existence of several substantial deficiencies will support a finding of fraud — even where the finding of deficiencies was based on the taxpayer's failure to meet his burden of proof. See *Jackson v. Commissioner*, 380 F.2d 661, 664 (6th Cir. 1967); *Driehorg v. Commissioner*, 225 F.2d 216, 218-219 (6th Cir. 1955); *Estate of Beck v. Commissioner*, 56 T.C. 297, 363-364 (1971). Here, in addition to the existence of substantial deficiencies for seven years, there was abundant independent evidence of fraud. As the court of appeals observed, "Zack's course of conduct was replete with 'badges of fraud'" (Pet. App. A-4). *George v. Commissioner*, 338 F.2d 221 (1st Cir. 1964), on which petitioner erroneously relies (Pet. 6), expressly states that the Commissioner need not prove the deficiency again in the fraud case — "the burden of proof was not on the Commissioner to prove any particular deficiency, or for every year." 338 F.2d at 223.

some payments to his customers and that this shifted the burden to the Commissioner to prove that he did not make payment equal to his unreported income. In support of this argument, he relies on *Richardson v. Commissioner*, 264 F.2d 400 (4th Cir. 1959); and *Perez v. Commissioner*, 33 T.C.M. (CCH) 946 (1974).

But as the Tax Court correctly recognized (43 T.C.M. (CCH) at 67), petitioner's reliance on these cases is entirely misplaced. In *Richardson* and *Perez*, the taxpayers had omitted amounts from income, but then proved to the court that they had made substantial amounts of deductible payments, which were closely related to the unreported income but which they had not claimed on their tax returns. The courts expressly acknowledged that, under the general rule, the taxpayer bears the burden of proving unclaimed deductions, but made a limited exception to that rule under the special facts before them. See 264 F.2d at 405; 33 T.C.M. (CCH) at 952. Unlike the taxpayers in *Richardson* and *Perez*, petitioner "failed to submit any credible evidence of whether and to what extent he made such advances" (43 T.C.M. (CCH) at 67).⁴ As a result, the Tax Court correctly held there was no reason to depart from the general rule that the taxpayer has the burden of proving unclaimed deductions.⁵

⁴Petitioner states (Pet. 11) that the "Tax Court expressly found that some advances were made." Petitioner, however, ignores the Tax Court's full statement, which is that, "[w]hile the record as a whole shows that some illegal cash payments were undoubtedly made to some of petitioner's customers in some years, *there is nothing to establish the large amounts that petitioner claims*" (43 T.C.M. (CCH) at 66; emphasis supplied).

⁵Petitioner's suggestion (Pet. 10-12) that the Commissioner had failed to investigate whether he had made the alleged payments is contrary to fact. During the course of his investigation, the Commissioner made repeated polls of petitioner's former customers to determine whether they had received payments from petitioner, and those surveys indicated that he had not made payments (43 T.C.M. (CCH) at 66).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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MARCH 1983